The Reserve Bank is preparing to cut interest rates

(Published as an op-ed article in the Australian Financial Review on 6th August 2008)

The opening sentence of the statement released by Reserve Bank Governor Glenn Stevens following yesterday's Board meeting was exactly the same as it has been after each of the four previous meetings: 'the Board decided to leave the cash rate unchanged at 7.25 per cent'.

However, whereas the final paragraph of the statements released after each of the four previous Board meetings had begun with the words, 'weighing up the available domestic and international information, the Board's judgement is that the current stance of monetary policy remains appropriate', yesterday's statement, after again 'weighing up the available domestic and international information', concluded that 'the Board's view is that scope to move to a less restrictive stance of monetary policy in the period ahead is increasing'.

In other words, the Reserve Bank is preparing the ground for a cut in official interest rates – without doubt before the end of this year, and quite possibly as early as next month.

Unsurprisingly, given the flow of economic data and anecdotal evidence over the past month, the Reserve Bank is now more confident than it had been hitherto that domestic spending will 'remain subdued' - and hence more assured that inflation will 'decline over time', subject to the proviso that 'wages growth remains moderate'.

The tightening of monetary policy over the past year has of course been explicitly calibrated with a view to inducing a period of weaker growth in demand. But it is possible that the Reserve Bank now sees some risk that growth in demand could turn out to be weaker than required to bring inflation down gradually to within the 2-3% target band over the next two years.

As yesterday's statement implicitly acknowledges, financial conditions have become tighter than the Reserve Bank intended over the past couple of months, as a result of 'additional rises in market interest rates and tougher credit standards' – developments which it probably would not have foreseen at its July meeting, but whose effects will have been broadly similar to another increase in official rates.

The Reserve Bank Board did not think an additional tightening of monetary policy was warranted last month, and it is even less likely to have thought so at this month's meeting in view of developments in the economy over the intervening weeks.

Indeed, it is possible – and the minutes of yesterday's meeting, when released later this month, may confirm – that the Board discussed the case for cutting rates this month in order to offset the most recent market-induced tightening in financial conditions.

However, as was the case when the Board contemplated raising the cash rate by 50 basis points at its February meeting, this may have been too much of a surprise for financial markets. It could also have risked being mis-interpreted as a sign that the Bank was responding to fears that the economy is on the precipice of a recession.

Clearly that is not the Reserve Bank's view. The Governor's statement speaks of 'subdued outcomes' for consumer spending, a 'softening' in business activity, and 'early signs of an easing' in labour market conditions – not of an actual or possible contraction in these or any other indicators of economic growth.

Indeed the statement again reiterated the 'substantial' contribution which the continuing rise in Australia's terms of trade will make to national income and 'ability to spend'.

And although the Governor's statement didn't make any reference to the recent decline in oil prices or to the latest round of income tax cuts which commenced at the beginning of this month, they may provide some impetus to household spending which was absent during June.

However, yesterday's statement is likely to cement expectations of an initial rate cut at next month's meeting, followed by a second easing before year-end if market conditions deteriorate further or domestic spending remains subdued. Further interest rate reductions are likely to occur during 2009 if a downward trend in inflation becomes evident as the year unfolds.

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